DOW THEORY LETTERS INC.

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P.O. Box 15196
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40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

April 4, 1966 Letter 319

THE MARKET: It is now clear that we are to have a full upward correction of the severe February-March decline. Normally, a secondary upward correction will retrace 1/3 to 2/3 of the ground lost on the preceding decline while consuming approximately three weeks to three months. Such a recovery could take Industrials to the 940-967 area, Rails to the 252-260 area, and this type of rise could carry into May or June.

In the last Letter (318) I noted that "...the public was clearly unmoved by the February-March decline, and they are just as clearly very enthusiastic about the rally from the March low." That enthusiasm has now turned into almost reckless speculative abandon, and over the past week we have seen some stocks advance as much in a day as they will earn in the next three to five years. On the American Exchange volume has soared, and one newspaper headlined,"Amex Turnover Biggest Since 1929." Such boiling markets are characteristic of major top areas. As a rule, this type of market continues until the speculative activity "burns itself out." Then, watch out.

The rapidity and violence of this market is now worth commenting upon. From December, 1965 to February, 1966 the Industrial Average advanced 56 points. From February, 1966 to March the Dow dropped 84 points. The Dow is heading up again, and the pace is fast. The drop from the February, 1966 peak started (deceptively) a day after both Averages had pushed to all-time highs. There was little warning at the turn, and the subsequent decline came very quickly, with losses for the first three weeks (from the February peak) occurring at a much greater rate than was seen during the May-June, 1965 correction. My guess is that the turn from the current rally is going to be even more sudden, more "unexpected." I would also guess that when the next reversal comes, the market is going to drop in earnest with little opportunity to get out. The current rally should be the rise in which speculation exhausts itself. It could be a period to remember, and all market students should note it well.

The Composite Chart shows the two leading industrial averages rebounding from their lows. The 10-day average of advances and declines has assumed the bullish position. New lows have bottomed out. Odd-lotters have shown less inclination to buy, as is normal in a rising market.

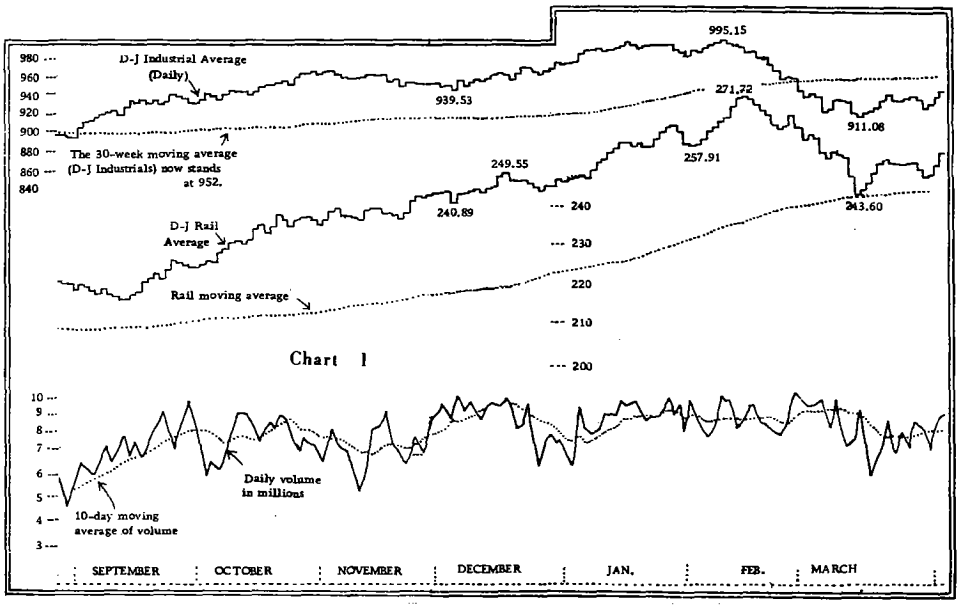
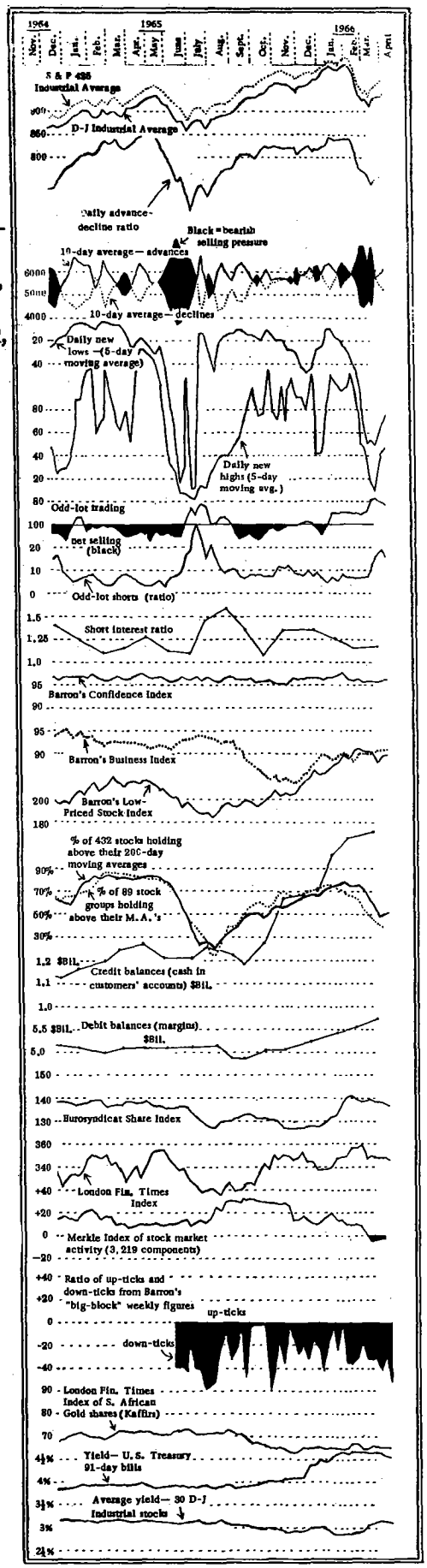


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
Net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

One factor on the bullish side of the ledger is worth discussing at this time. Debit loans (margin accounts) have risen to the highest point in history. and this is ordinarily a strong plus for the market. It means that the speculators are "up to their ears" in stocks on margin, stocks which they expect, naturally, to sell at higher prices. Unlike the odd-lotter, the speculators (who tend to use their margins) have in the past tended to be right. Judging from this, can we expect a new or perhaps final surge in stocks? I do not know, but I would not write off such a possibility. One thing seems clear, however. If such a late speculative movement is to develop, the probabilities are that it will be the low-priced and specialty shares that will receive the real attention, not the big "Dow-type" stocks.

Big Block "downsticks" have been running very heavy since January, suggesting continuing big money distribution. The rate on the 91-day Treasury bills has dropped ¼% in the past month, thereby narrowing the adverse spread between bill and stock yields. Conclusion: secondary bullish forces are now in effect, while the primary trend of the market should still be considered bullish (regardless of the many factors which, in this writer's view, suggest a position of defense or safety).

Speculation Rampant: I have made many references during 1966 to the persistent distribution in the investment sectors of the markets. I have repeatedly drawn attention to the trend of the bond market, a falling bond market ultimately exerts pressure on equities. In Letter 314 I documented the thesis that when utility and bond prices decline together, it spells trouble for the stock market. A few weeks later, in Letter 316, I wrote about the steady distribution which was taking place in some of the "backbone of the economy" stocks with particular emphasis on General Motors and DuPont. I noted that a bearish trend in these two giants has always been an adverse consideration for the whole market. In the same Letter I included tabulations showing that only 12 of the 30 Dow Industrial stocks were holding above their moving averages. When the big stocks are under distribution, I noted, the rest of Wall Street, including the speculative leaders, is living on borrowed time.

One of the most remarkable phenomena of 1966 is the fantastic rise in confidence and the spread of gambling fever. The fact is that many sectors of Wall Street have become highly speculative. Computers are coming increasingly to the fore, pinpointing trends for eager traders to pounce on, serving to direct sentiment from values to "movement" and "action." The market letter-writing business is bursting at the seams; analysts are competing with each other in attempting to "call" every short-term and minor movement. The sheer amount of investment advisory advertising in the financial pages is assuming frenzied proportions. An even more interesting trend is seen in the wild gyrations of the high-priced glamour issues (as opposed to the low-priced "cats and dogs"). Selected airlines, electronics, television and other stocks have been rocketing and many of these are moving with such velocity that it becomes obvious that very large chunks of speculative money have been chasing these issues. This big speculative money cannot be equated with "the public," as we know the public. What is going on, then? On March 8 The Wall Street Journal included an article which directed attention to the fact that many funds are now speculating on a week-to-week basis in "hot issues." The pressure of performance-competition has brought this about. A research director was quoted as saying, "The funds are chasing trends now — they're not buying values any more." The April 2 issue of Business Week contains an article on the new "hedge funds." These funds hedge leveraged positions in fast-moving bullish stocks with shorts on bearish stocks. They are aggressive and are responsible for much of the action in selected "high flyers." One of the fund managers is quoted as saying, "What worries me about the market now is that we are all jammed up in a small group of stocks, most of them with small capitalization." I believe that this is exactly what is occurring, and I believe it's dangerous. The funds are now acting like wild-eyed boardroom sitters. The whole thing is particularly dangerous in the face of the desultory action by many "blue-chip" issues. If trouble should appear the door will not be big enough to allow all those who are speculating in glamour stocks to exit simultaneously. And if a dozen funds run for the door at once, someone is going to get hurt.

THE TIDE: At this stage of the market, I particularly want subscribers to avoid being caught up in the daily or very short-term view. In-and-out trading can be costly, and it can be extremely costly (to both nerves and pocketbook) near a major market top. It should be remembered that a bull market ends when the market has discounted the best. Once the best has been fully discounted by the Averages, conditions cannot get any better (by definition), they can only get worse on a long-term basis. Thus during a bear market time is on the side of the bear, because values during a bear market decrease through time. In fact, it occurs to me that this might be an excellent period in which to re-examine the principle of the primary trend.

The primary trend is the great tidal movement in the market and the economy. Like the tide of the ocean, the primary trend ultimately sweeps all before it. When the primary trend turns up (i.e. a bull market), it can be said that the long-term outlook for business, personal investments, stocks, real estate and corporate profits is favorable. Conversely, when the primary trend turns down (i.e. a bear market) the prognosis for all types of investments (with a few exceptions such as gold shares) is poor. During bear markets the value of "things" declines, people have less money, profits and dividends from investments are reduced, and the outlook for all types of business enterprise is unfavorable.

The great primary movements are periodically interrupted by contra-cyclical swings (which are often very deceptive), and we term these secondary reactions. Secondaries serve to correct the excesses of the preceding primary movement. Within the secondary movements the minor or daily movements occur, and these minor trends are often set off by spot news. Thus all three movements, primary, secondary and minor are always acting simultaneously upon the market. But interestingly, the public is usually most concerned with the very obvious minor trend, less with the secondary trend, while the more subtle force of the primary trend is seldom completely understood or acted upon by the public.

The major force behind the primary movement is the large investor. The crowd sometimes follows a primary movement (usually in the late stages), but just as often the crowd acts against the primary trend (for instance, by selling in the early stages of a bull market or buying in early stages of a bear market). The question then arises, if the primary trend is so important in investing, how can we recognize the turn from bear to bull or from bull to bear market? This is one of the most difficult procedures in investing, and there is no exact or sure answer. However, if we can discover major changes in "big money" sentiment, we will be provided with one of the best hints as to possible changes in the primary direction.

Here are some of the factors which should be watched for purposes of detecting primary reversals. Foremost is the gauging of investment "values." Value is dependent upon earning power, growth potential, safety, reliability and yield. The thirty Dow Industrial stocks represent a typical but time-tested "package"of investment values. In fact, it may be said that the trend of the Dow stocks provides us with one of our best clues as to the direction of investment money. All bull markets are characterized by a long-term rising trend in the Dow Averages (both Industrials, and the more speculative Rails), and all bear markets are characterized by a declining trend in the major Averages.

At the bottom of a bear market, when the primary trend is in the process of turning bullish, there is usually a great deal of public pessimism, little or no speculative interest in stocks, and, in fact, little interest of anv kind in Wall Street. Such periods are generally characterized by dullness in the market and abnormally low volume.

Conversely, at bull market tops, when the primary trend is in the process of turning down, the situation is apt to be the exact reverse. Volume is generally abnormally large, speculation is rampant, the public is vitally interested in stocks, optimism reigns, and there is little emphasis on yields or values. The main interest is centered on "What is going up?" and "How can I make a killing as quickly as possible?" Such conditions are ideal for the distribution of large quantities of stocks, and it is in this atmosphere that one is liable to see big investment interest liquidating their equity positions while preparing for the next bear market.

SUNDRY COMMENTS: Aside from the Communists themselves, deGaulle has probably been more thoroughly denounced by Americans than any other Free World leader. I have never agreed with this "consensus" appraisal. DeGaulle is, in my opinion, the only leader of a major nation who sees the trend of coming events, political, social and economic, correctly. DeGaulle is the only world leader who has surrounded himself with economists of the anti-inflation school. DeGaulle knows that through 5,000 years of history the spendthrift nations, the deficit-producing nations, the nations which have over-reached themselves, have fallen. DeGaulle's motto might be, "Gold and conservatism will win."

I want to introduce some significant quotes at this time, some quotes which I believe my readers (and particularly my readers in Washington) will find interesting. From Melchior Palyi's March 15 column: "...The Bank of France has practically overtaken the German Federal Bank. France is burdened by less than 500 million dollars of foreign claims of the liquid kind and has a gold-dollar reserve of 5.6 billions; Germany with a 5.7 billion dollar reserve faces foreign claims of more than three billion dollars." From the March 12 Economist: "With 29,000 teachers abroad, France is way ahead of any other country in the world in the export of its culture through the schools. France also continues to put more of its national product into aid than any other western country (1.3% of the gross national product on the strictest computations whereas no other country, on the same standards, gets near the 1% mark)."

From the March 17 New York Review of Books, article by Roland Steel: DeGaulle trumpets grandeur, but France is not at war with anyone, does not have army garrisons overseas, and its quite content to let others live under whatever regimes they please. Under him France has been a troublesome ally, but before him, as we seem to have forgotten, France was the joke of Europe .....DeGaulle has little use for the present form of NATO, and even less for a world gendarmery run from the LBJ ranch. But then why should he? His job is not to be deputy sheriff to Washington, but to restore France to her self-respect, and this he has done triumphantly."

But what about the latest "French outrage," the withdrawal from NATO? What is deGaulle trying to do to the Western defense system? France does not want to be drawn into a nuclear war of Asian origin, and it does not want to be LBJ's "automatic nuclear partner" in a potentially explosive situation which deGaulle does not believe in. Removal of NATO bases will mean that France will step aside if the war in Vietnam becomes a nuclear war with China. In other words, France does not want to be in a nuclear war unless she also decides to enter that war. The key word is "decides," and deGaulle does not want any automatic French entry into a possible Sino-American disaster.

In Elie Abel's book, "The Missile Crisis," there is a telling story. During the Soviet-U.S. confrontation over missiles in Cuba, the Presidential envoy, Dean Acheson, saw deGaulle and informed him that the U.S. was prepared for nuclear war with Russia. DeGaulle answered, "May we be clear from the start. Are you consulting or informing me?" Acheson said he was informing. But if Russia had not backed down, France might, within a matter of hours, been in a position to be annihilated by a Russian attack against the U.S. and all NATO bases. All this could have occurred over a Caribbean Island in which France had little or no interest. It would have occurred without U.S. consultation of France or any other NATO ally.

DeGaulle does not want to be in that position again. He is not demanding the scrapping of the Atlantic Pact. He is asking for removal of NATO bases not under French control, so that nuclear war will not come to France unless it is her decision to engage in nuclear war. It can all be put this way: deGaulle has no faith in U.S. political or economic policies. He wants to cut France loose from any tie which he feels could ultimately be disastrous for France. If deGaulle's judgment of where U.S. political and economic policies are headed is correct, then deGaulle's actions are not illogical.

The Eager Gold Buyer

France Buoys Reserves by Purchasing 30 Tons From U.S. Month After Month

By RICHARD E. MOONEY
Special to The New York Times

PARIS, March 25—Month after month France buys another 30 tons of gold—or more—from the United States. Is there a limit? The gold portion of French monetary reserves has risen now to 87 per cent, from 72 per cent when the gold-buying tactic began, and the total reserves have risen to $5.5-billion.

The buying began at the end of 1964. It is part of President Charles de Gaulle's determination to make his country independent, in the same sense as his newest attack on the North Atlantic Treaty Organization.

As stated previously, one excellent clue as to the direction of investment money is the actual trend of the Industrial Average. The type of stocks which comprise the Industrial Average generally hold little interest for the public. The public wants stocks for action, not "stodgy" issues such as duPont, General Foods and Owens-Illinois. Nevertheless, in the early and middle stages of a bull market it is these investment-grade issues which lead the market higher (years may pass before the speculative issues stir, move up, and finally "take off"). But towards the end of a bull market, while the "cats-and-dogs" and specialties may be providing the action, the Industrial Average oftengrows "tired," loses momentum, and appears to suffer from lack of interest.

One of the best (and oldest) methods of gauging the strength of the Industrial Average is by watching its position in relation to its own 30-week moving average. During bull markets the Dow tends to hold persistently above its moving average except for periods when a secondary correction may temporarily drive it below the moving average. Most such reactions, however, are set off by a specific news event. But the relationship of the Industrial Average assumes a particular significance in the very late stages of a bull market, in that period which Hamilton termed "the third phase." For somewhere in the third phase, an area characterized by great speculative activity, inflated investment values, high interest rates, low equity yields, the high-grade stocks will turn down. This decline may appear to come "out of a clear blue sky." At such times, there is always the danger that a major bear market has started.

All of which takes us to the present. On February 9 the Averages turned down from historic highs. No specific news event set off the decline. On March 1 the Industrial Average plunged below its 30-week moving average (see chart 1), continuing to a low of 911.08. At the March 15 low, the Industrials stood 39 points below their moving average. Following this, a rally materialized.

I consider the current relationship of the Dow and its moving average to be very important. Furthermore, it will be equally important to note whether this rally can carry Industrials back to a position above the moving average or whether, within perhaps days or weeks, the rally will peter out, and a new downward movement will occur.

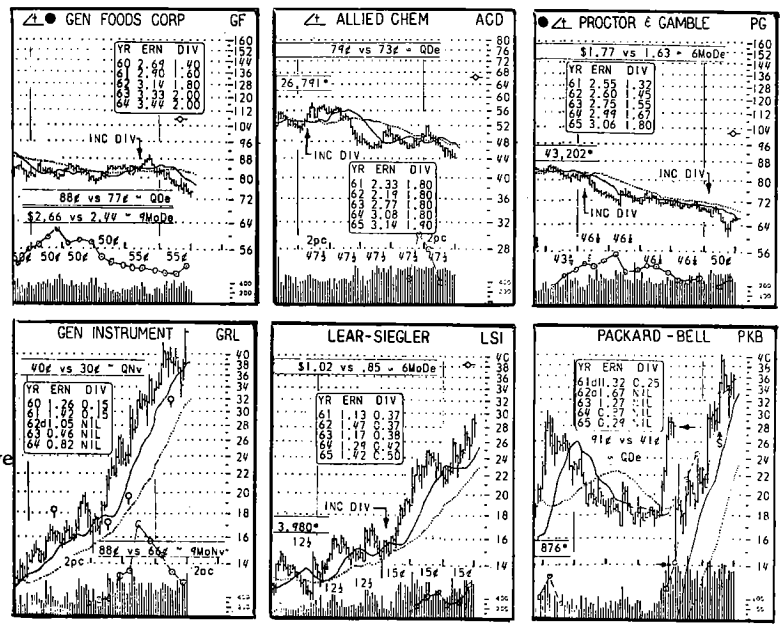
A second point of interest in gauging the situation is the direction of the moving average. During a true primary bear market I would expect the moving average to be in a declining trend perhaps 80% of the time with the Dow tending to hold persistently below it (except during temporary periods of violent upward corrections). It should be remembered that in about a month we will be removing figures in the 930 range from the 30-week moving average. This means that if the Industrial Average a month from now is in the low 900's (or below), the moving average will start a declining phase. I would consider a declining trend in the moving average very bearish. But that is not something we can predict, it is a situation which we will identify, if or when, it occurs.

CREDIBILITY: History suggests that toward the end of every great bull market, events occur which strain the credibility of "intelligent men." We appear to be at such a stage now. Here are a few of the phenomena which might serve our credibility: (1) The U.S. and world monetary situation is becoming climactic. The U.S. Government is now back-tracking on its previously optimistic estimate for a turn for the better in our balance-of-payments. Indeed, we are now being prepared for a B.O.P. situation which could be worse than last year. (2) With new civilian rioting in Saigon and Da Nang, I feel the U.S. "position" on Vietnam is being subjected to the test of credibility. Should Premier Ky fall, the U.S. would stand to lose face regarding our whole Vietnam stance, and the Honolulu conference would go down as a mockery. (3) Keynesian economics is now "coming apart at the seams," and I commend to readers the editorial on the front page of Barron's, April4. (4) The stock market itself is running into a credibility strain as interest in big blue-chip stocks flags and as money switches to the glamour issues. Although the market looks "strong," it is a situation which strains the credibility of many veteran observers who have watched similar situations in the past.

STOCKS: The six small weekly charts shown here present a picture of the "market" in miniature. The first three charts, all Dow stocks, have "topped out" and are attracting little buying interest. These three stocks are giants in their field; their combined sales run into the billions. The lower three stocks are in the currently "hot" electronics group, and they are attracting a great deal of buying. They are not, however, "backbone of the economy" stocks. The six charts serve to highlight the split character of the market today. The outcome of this "tug of war" should be most interesting, and ultimately we will see a broad trend that will bring harmony to the market. In other words, in time all stock will tend to move together.

At this writing 8 out of the 30 Dow stocks are above their 200-day moving averages. These are Alcoa, Kodak, Int. Nickel, Int. Harvester, Swift, United Aircraft and Westinghouse. Kendex, an excellent computer service (Box 245, Memphis, Tenn. 38101) arranges the Dow stocks in order of strength each week, and they list the first five Dow stocks in order of strength as (1) Int Harv., (2) Kodak, (3) Unit. Aircraft, (4) Westinghouse, (5) Alcoa. Weakest Dow stocks are (26) Amer. Tob., (27) Am. Tel, (28) Gen. Foods, (29) Texaco, (30) du Pont.

A number of analysts are now reminding their subscribers that historically, markets wind up with a surge in speculative issues, a topping out in these issues, and then a final rise in the Dow stocks. The theory is that we are in the speculative stage now, and that before general danger can be expected, we must see a final surge in the Dow issues. My own opinion is that it could easily work out this way, but the "normal progression" has been receiving a little too much publicity for my money.



Charts above courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas